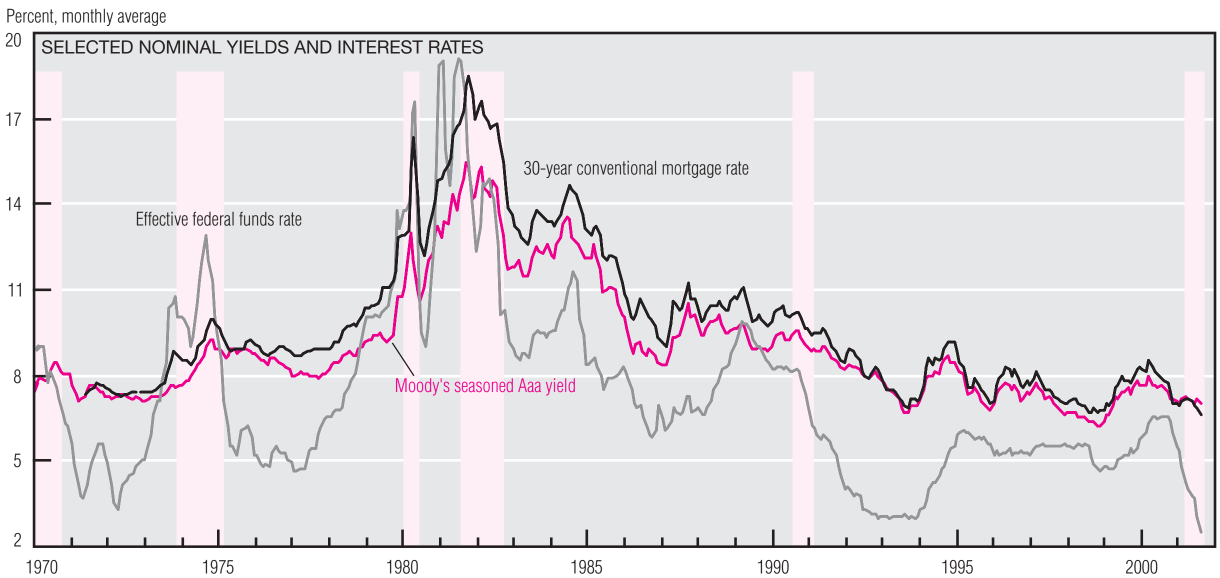
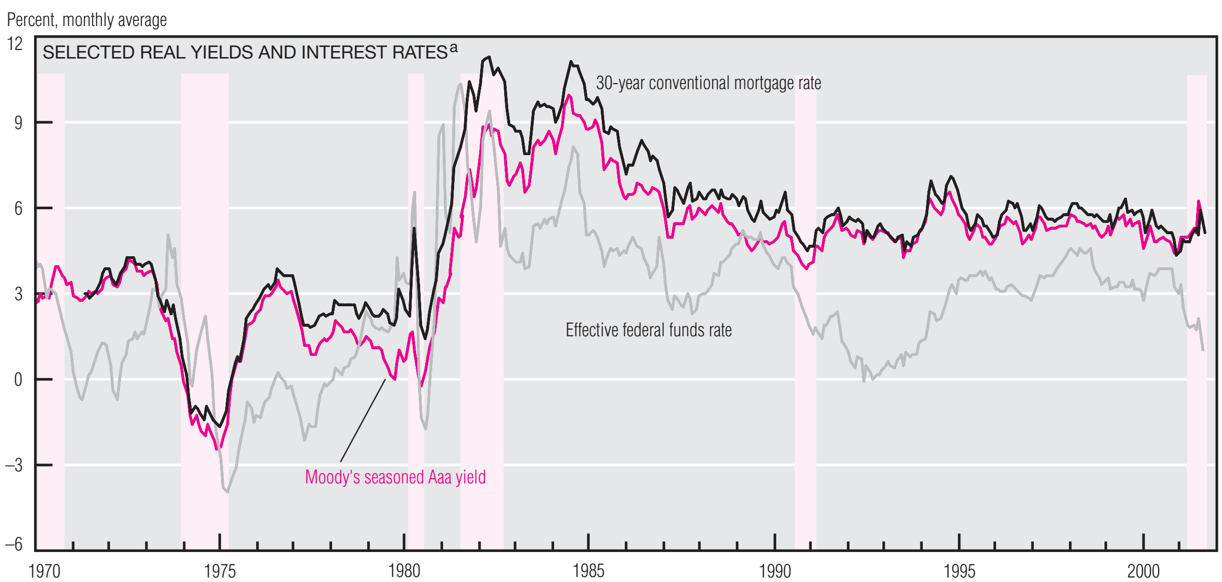
Money and Financial Markets





NOTE: Shaded areas mark NBER-defined recessions.

a. Nominal rates and yields minus the 12-month percent change in the Personal Consumption Expenditure Chain-type Price Index.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Releases*, "Selected Interest Rates," H.15; and National Bureau of Economic Research, Inc.

Many interest rates have fallen to their lowest levels in 30 years (except for a brief period in 1998 after the Asian financial crises and the Russian default). The benchmark effective federal funds rate averaged just 2.49% in October. After the Federal Open Market Committee's November 6 decision to cut the intended federal funds rate 50 basis points (bp) to 2%, the fed funds rate fell even further, averaging just 2.01% for the week ending November 21. Likewise, financing costs for both individuals and corporations have dropped: The average 30-year conventional mortgage rate was 6.62% in October, and the Aaa-rated corporate bond yield dropped to 7.03%. In November, despite a rate cut, the 30-year mortgage rate and Aaa yield moved upward, averaging 6.75% and 7.16% for the week ending November 21.

None of this should be terribly surprising. During periods of economic weakness, the Fed characteristically pursues an aggressive policy of rate cutting to avoid retarding recovery. Although most private-sector yields are not tied directly to the fed funds rate, they tend to follow a similar pattern over longer periods. On November 26, the National Bureau of Economic Research's (NBER) Business Cycle Dating Committee announced that the longest economic expansion in U.S. history ended early this year, confirming many analysts' contention that the U.S. economy is experiencing a recession.

What may seem surprising is that the real costs of borrowing have not

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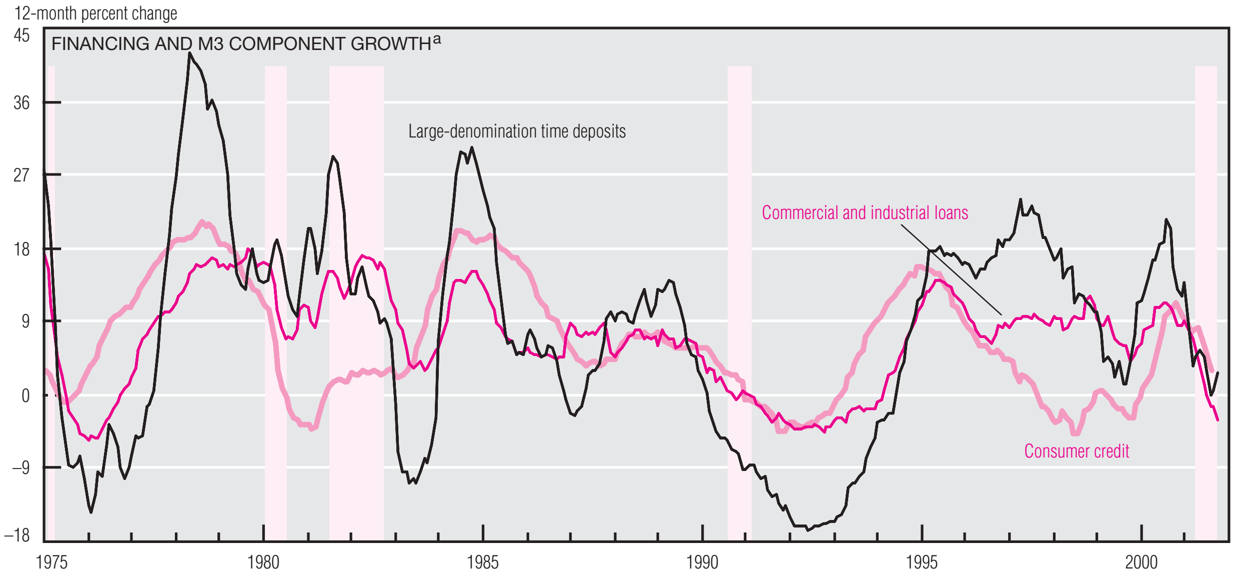

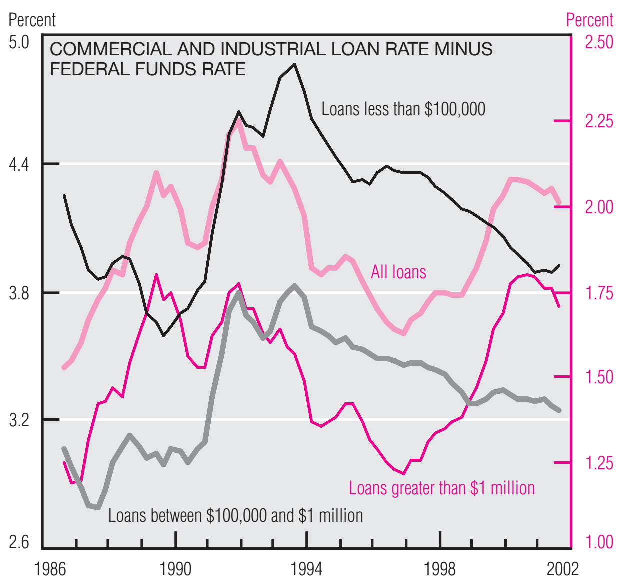

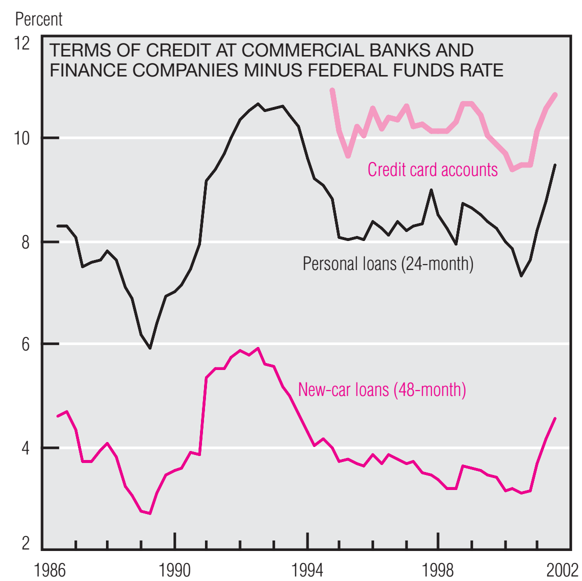

a. Shaded areas mark NBER-defined recessions.

SOURCES: Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Releases*, "Survey of Terms of Business Lending," E.2, "Consumer Credit," G.19, "Money Stock and Debt Measures," H.6, and "Assets and Liabilities of Commercial Banks in the United States," H.8; and National Bureau of Economic Research, Inc.

reached historical lows comparable to the nominal costs. Estimates of real interest rates subtract from nominal interest rates the portion that lenders may demand to cover inflation. The real effective fed funds rate, while lower than in recent years, has yet to dip below levels experienced in the early 1990s and is far from the lows of the mid-1970s and early 1980s. Real 30-year mortgage rates and Aaa yields have risen in the course of this year, behavior that is consistent with a belief that long-term prospects have improved and the economy may be headed for recovery. Ultimately, real rates should reflect the economy's long-term growth potential.

Other things being equal, low real interest rates and bond yields favor borrowers. However, commercial and industrial (C&I) loans and consumer loans have fallen sharply in 2001. C&I loan growth averaged 9.4% (12-month percent change) in 2000 but only 2.8% during the first 10 months of 2001. Banks may finance C&I loans by issuing certificates of deposit, which are counted within the large (greater than $100,000) time deposit component of the M3 monetary aggregate. (C&I loans and large time deposits show a high correlation—0.86 since 1975.) Large time deposits' growth rate has fallen almost exactly in step with C&I loans, from a 15.9% average last year to 4.7% in the first 10 months of this year. Although consumer credit growth increased slightly over the same horizon, from an average of 6.1% in 2000 to 6.8% so far this year, consumer loan growth peaked in

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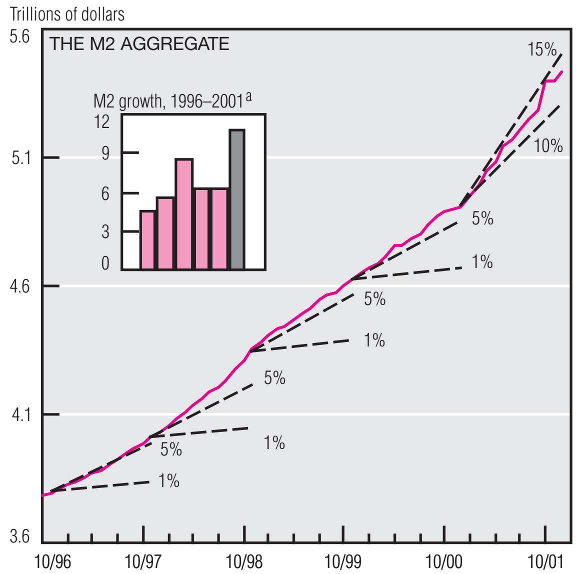

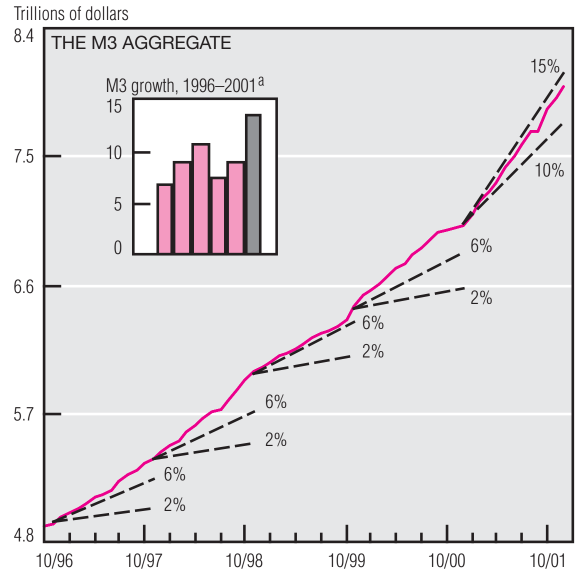

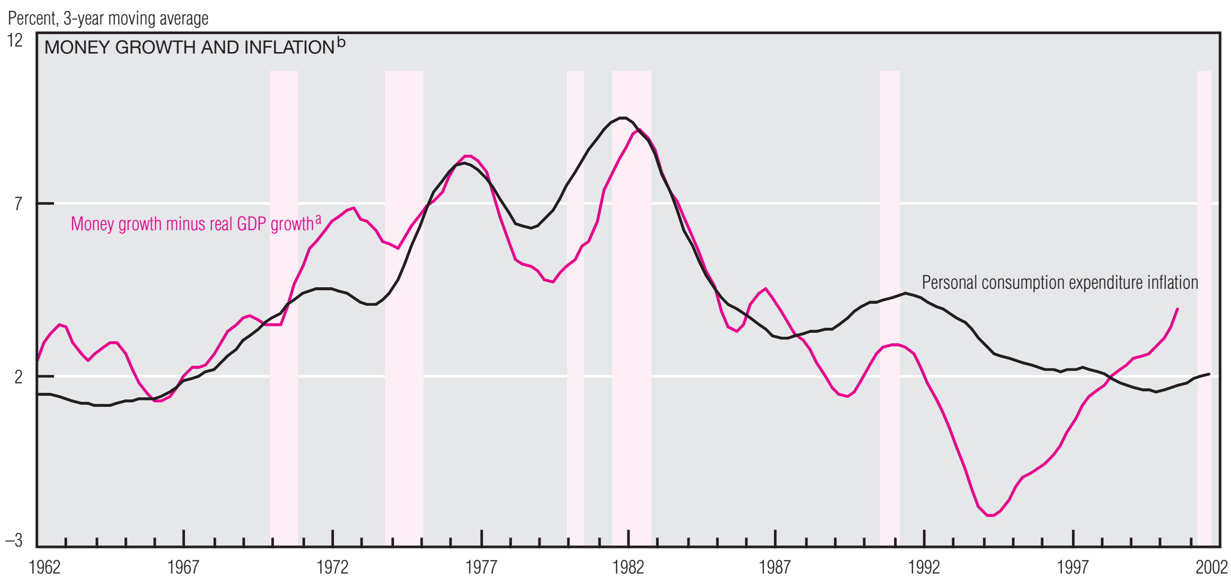

NOTE: Last plots for M2 and M3 are estimated for November 2001. Dotted lines for M2 and M3 are FOMC-determined provisional ranges. Prior to November 2000, dotted lines are FOMC-determined provisional ranges. Subsequent dotted lines represent growth in levels and are for reference only.

a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. The 2001 growth rates for M2 and M3 are calculated on an estimated November over 2000:IVQ basis. Data are seasonally adjusted.

b. Shaded areas mark NBER-defined recessions.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Releases*, "Money Stock and Debt Measures," H.6; and National Bureau of Economic Research, Inc.

October 2000 and has been declining steadily ever since.

The spread between C&I loan rates and the fed funds rate—a measure of the premium that business borrowers must pay—has been nearly flat, while the spread between the fed funds rate and various types of consumer loan rates has increased markedly. From 2000:IVQ to 2001:IIIQ, spreads on new car loans, personal loans, and credit card accounts rose 1.43, 1.88, and 1.36 percentage points, respectively. It seems plausible that the decline in commercial lending reflects economic uncertainty, while the drop in consumer borrowing may be related more directly to increases in the real cost of borrowing.

Changes in the real cost of borrowing and lending are eventually reflected in the growth of monetary aggregates through their opportunity cost. As nominal interest rates fall, it is less costly to own non-interest-bearing financial assets, and individuals often prefer to hold safer, more liquid assets. The broad monetary aggregates (M2 and M3) are growing faster now than at any time in the last 15 years. Estimated November year-to-date growth is 10.7% for M2 and 13.9% for M3.

The Quantity Theory says that inflation will reflect the excess of money growth over real GDP growth when velocity is reasonably stable. Velocity was almost trendless for the three decades prior to the 1990s, but then drifted upward, allowing money growth to decelerate relative to inflation. If velocity were to stabilize around the higher levels of the late 1990s, the recent breakneck pace of money growth could bring a fresh bout of inflation.